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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	CC Docket No. 96-45
Federal-State Joint Board on	)	
Universal Service	)	CC Docket No. 97-160
	)	
Forward-Looking Mechanism for	)	DA 98-715 - USF Proposals
High Cost Support for Non-Rural LECs	)	

COMMENTS OF THE COMPETITION POLICY INSTITUTE

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Comments of the Competition Policy Institute

In its Public Notice 98-715, the Common Carrier Bureau solicited any additional proposals to revise the methodology for determining universal service support for non-rural carriers serving high cost areas. The Competition Policy Institute (CPI) appreciates the opportunity to comment on proposals submitted by other parties to this case. CPI is an independent, non-profit organization that advocates state and federal policies to promote competition in energy and telecommunications markets in ways that benefit consumers.

In these Comments, we will describe a proposal for the Commission's consideration that responds to, and is partly based on, some of the proposals submitted on April 27, 1998 by other parties. In brief summary, the proposal recommends that the FCC structure the federal high cost fund for non-rural LECs to reflect two principles:

1) **Size of the Federal Fund:** The federal high cost fund for non-rural LECs, as a fraction of the total support required, should not exceed the interstate retail revenue percentage (i.e., interstate retail telecommunications revenues divided by total retail telecommunications revenues.) In 1996 this percentage was 38%.
2) **Distribution of the Federal Fund:** The federal high cost fund for non-rural LECs should be distributed so that, for each Census Block Group, the federal fund would support 100% of the forward looking economic costs above a uniform national threshold. The threshold is selected so that the system spends exactly the target federal fund.

Introduction

By now the Commission is very familiar with the objectives to be achieved by state and federal universal service support mechanisms. We will not recite here the litany of purposes that can be found in nearly every of set of comments filed in this docket. Instead, we begin by noting an obvious, but rarely stated, implication for any federal universal service plan for high cost areas.

One of the principles of universal service announced in the Telecommunications Act of 1996 is to ensure that consumers in "rural, insular and high cost areas should have access to telecommunications and information services . . . at rates that are reasonably comparable to rates charged for similar services in urban areas."[1] The 1996 Act contemplates calls for the creation of a federal fund and state funds to meet this goal. Because local telephone costs vary by region and geography, the federal high cost fund must shift telecommunications revenues among regions and among states if it is to serve this principle. To suggest that such shifting will not (or should not) be an effect of a federal universal service plan is mistaken. Since costs vary among regions, prices will vary among regions. This means ultimately that the "reasonably comparable" standard can be fulfilled only by shifts of revenues among regions and states. A universal service system that merely re-labels the implicit support now paid by consumers in a state, keeping costs and revenues inside that state, cannot achieve the purposes announced by Congress.

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1. 47 U.S.C. 254(b)(3)

From the beginning, CPI has advocated that the federal universal service fund (and any state universal service funds) base their funding on an assessment against the combined interstate and intrastate revenues of interstate carriers.[2] We reiterate that position now and suggest that relying on combined interstate and intrastate revenues will yield the most rational, coherent and stable universal service fund. By taking the combined revenues approach, both the state and federal high cost funds are more likely to be predictable, sufficient and competitively neutral.

But we also recognize that some states have raised objections to the Commission using the combined revenue approach. They argue that the Telecommunications Act of 1996 did not authorize the Commission to assess universal service support based, in part, on intrastate revenues. We think the arguments against the combined revenue approach are wrong both as a legal and policy matter. Nevertheless, the threat of litigation over this issue is something that the Commission understandably must consider seriously.

These objections, and the resulting decision of the FCC to use only interstate revenues in its design of a federal fund, substantially limit the FCC's ability to accomplish appropriate interstate and interregional subsidies. This limitation has implications for both the size and design of the federal high cost fund.

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2. See the *ex parte* submission to the Federal-State Joint Board on Universal Service, dated October 4, 1996: "An Integrated Universal Service Plan proposed by the Competition Policy Institute."

Being able to consider only interstate revenues limits the size of the federal fund in an obvious way: the "carrying capacity" of an interstate-only fund is much less than that of a combined revenues fund. Indeed, 1996 interstate retail revenues comprised only about 38% of the total U.S. domestic retail telecommunications revenues. On a practical level, assessing interstate revenues at a higher rate than intrastate revenues creates opportunities for arbitrage and incentives to mis-classify jurisdictional revenues. At a principled level, CPI suggests it is simply unfair to ask customers of interstate services to bear the entire burden of universal service support when intrastate services would bear little or none of the responsibility. Assessing interstate long distance carriers also has a new developing competitive component: competition from Internet-based long distance providers will further limit the capacity to tax interstate services unless the Commission decides to include these new services within the scope of assessment.

CPI urges the Commission to continue to seek an agreement with state regulators that would permit the use of combined interstate and intrastate revenues for both state and federal universal service funds. Until recently there might have been some uncertainty about the effect of various funding proposals on the fortunes of each state. The substantial inquiry undertaken by the Commission, the Joint Board and others to study the universal service issue has supplied all of the data needed to assess various funding methods. But we fear some states may still vote their pocketbooks and oppose the combined revenue approach. For that reason, we offer these comments under the assumption that only interstate revenues will be considered in the design of the federal high cost fund for non-rural carriers. If that assumption proves wrong, CPI may make a different recommendation than the one contained in these Comments.

In view of the relatively smaller federal fund and the accompanying limit on its ability to shift support among states and regions, the federal fund must be structured to equalize the residual burden left to the states as much as possible. Unless the Commission takes these limits into specific consideration, it is possible that the federal fund will either be inadequate to accomplish the goals of the Act or will not leave states in a position to structure rates and state high cost funds in a way to achieve the "reasonably comparable" principle. With this background, CPI offers the following suggestions for the Commission's consideration in the design of a federal universal service fund:

Federal Share: A key question in the design of a federal high cost fund is this: How big should the federal fund be? Assuming the federal fund does not cover the entire gap between cost and affordable prices in each high cost area, the federal fund will be some fraction of the total high cost support required. It must be large enough to accomplish the required subsidy shifts, but not so large as to overburden the interstate revenue base on which the fund relies. The Commission has some flexibility in its decision. However, we suggest that the restriction to interstate revenues places an obvious ceiling on the size of the federal fund.

CPI recommends that an upper limit on the federal high cost fund for non-rural LECs should be set so that the ratio of the federal fund to the total support required is equal to the ratio of interstate retail revenues to the total retail interstate and intrastate revenues. In other words:

$$\frac{\text{Size of Federal Fund}}{\text{Total Support Required}} = \frac{\text{Interstate Retail Revenues}}{\text{Total Retail Revenues}}$$

In 1996, the fraction on the right (interstate retail revenue percentage) was approximately 38%. Following this principle, if the total universal support required for non-rural LECs is $3.0 billion, then the ceiling on the federal fund would be about $1.14 billion.

The reasoning behind this provision is straightforward. If the federal high cost fund supplied all needed support and used combined interstate and intrastate revenues, then interstate services would bear 38% of the total burden. But the burden on interstate revenues should not increase simply because the Commission is prohibited from considering intrastate revenues: assessments on interstate services should continue to support 38% of the high cost subsidy. Stated another way, limiting the federal fund to 38% of the total ensures that the "tax rate" applied to interstate retail revenues will not be higher than the average tax rate applied by states to intrastate revenues. If the Commission is forced to work only with interstate revenues, this is a reasonable manner to divide responsibility between state and federal high cost fund efforts.

Distribution of the Federal High Cost Fund: Because of the limits placed on the FCC by the restriction to interstate revenues, it is important that the federal high cost fund for non-rural carriers be carefully targeted. We recommend that federal high cost funds be directed to those subscribers served by high cost facilities in the following manner: for each geographic area (e.g., Census Block Group) the federal fund would pay 100% of the costs above a uniform national "distribution" threshold[3]. The distribution threshold should be selected so that the system spends exactly the target federal fund. For example, the federal fund might cover costs in excess of $44 per line in all Census Block Groups of non-rural LECs, depending on the size of the federal fund.[4] Under this proposal, the federal fund would not subsidize costs below this distribution threshold: that effort would be the responsibility of state funds.

The Commission will recognize that this concept is related to the "30-50" proposal of USWest and shares many of the same purposes as the USWest proposal. In USWest's proposal, the federal fund would cover all costs above $50 per line in addition to 25% of costs between $30 and $50. CPI's proposal lowers the $50 threshold (to $44 in the example) but eliminates the 25% cost sharing in lower ranges of costs. In practice, this means that federal funds will be

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3. This distribution threshold is not the same $30 revenue per line benchmark adopted by the Commission in the ***Universal Service Order***.

4. In its ***Report to Congress*** on Universal Service, the Commission suggests that no state should receive less high cost support under the new system compared to the support it receives under the existing High Cost Fund. To accomplish this, CPI would include a "hold harmless" provision to ensure that each state received the larger of its previous support or its new support in the first year. Differences between these support levels, if any, should be phased out over five years.

targeted to the highest costs geographic areas, leaving all states with the comparable task of covering costs between $30 and $44 (in the example). Compared to other distribution mechanisms, this method would focus federal USF funds more precisely on the highest cost areas instead of focusing most of the support on medium-cost areas. Given the limitations on the federal fund imposed by the interstate-only method, this is a reasonable means of allocating federal high cost funds among customers, companies and states.

The actual numeric evaluation of this proposal depends on the choice of a cost proxy model, and upon the distribution of high cost customers above various threshold levels. These distribution data were not immediately available to CPI in preparing these Comments. For that reason, CPI is not able to illustrate the precise effect of the proposal at this time. Nevertheless, the essential element—distributing a limited federal fund to cover 100% of forward-looking economic costs above a threshold—applies to any choice of cost proxy model.

Conclusion

CPI appreciates the opportunity to comment on some of the proposals filed the Commission to modify the methodology for determining and distributing federal high cost fund support to non-rural carriers. We look forward to continued discussion with the Commission, the Common Carrier Bureau and interested parties to develop an effective and equitable federal high cost fund for non-rural LECs.

Respectfully submitted,

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I, Bridget J. Szymanski, hereby certify that on this fifteenth day of May, 1998, copies of the foregoing Comments of the Competition Policy Institute were served by hand or by first-class, United States mail, postage prepaid, upon each of the following:

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